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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

KENNETH R. CUNNINGHAM, ET AL,
Petitioners

v.

RAYMOND J. DONOVAN,
SECRETARY OF LABOR,
Respondent

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITIONERS' REPLY BRIEF

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I

REPLY POINTS

1. **This case is of national importance.**

2. **Congress did not intend to place the burden of proof on prudence on both parties.**

3. **Respondent cannot meet his burden of proof on the Section 404 issue with testimony from his biased expert.**

4. **The undisturbed district court's finding on value is conclusive on the Section 406 issue.**

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PETITIONERS' REPLY BRIEF

STATEMENT

The following is Petitioners' reply to Brief for the Respondent in Opposition to the petitioners' petition for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit.

ARGUMENT

First Reply Point

This case is of national importance.

Respondent questions the national importance of this case by questioning petitioners' statement that the decision below will have a "profound impact upon the viability of employee stock ownership plans in closely-held companies" (Resp. 14). The national importance of this case and its potential impact are addressed in detail in petitioners' Application for Stay filed in connection with this petition.[1] ESOPs continue to be of national importance.[2]

This case is of national importance because a United States court of appeals, in a case of first impression, has erroneously interpreted a major piece of national, economic legislation in an area where clear and accurate guidance is necessary, and where the respondent has failed his congressionally mandated duty to provide that guidance.[3] The error below in interpreting ERISA affects the tax laws as well.[4]

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1. That portion of the Application addressing this issue is excerpted in Appendix A.

2. See Barron's, May 28, 1984, *No ESOP Fable*, at 30, col. 1., Appendix B.

3. The Secretary argues that this failure is immaterial in this case. (Pet. 14, n.11) Contrary to this argument, the regulations mandated under Section 3(18)(B) would have dealt with procedures for valuation of closely-held stock for ESOP purposes—a major issue in the case tried before the district court, and the heart of the testimony of the Secretary's discredited and only expert witness.

4. Section 4975(a) of the Internal Revenue Code imposes a tax on a "prohibited transaction" unless the transaction is exempt from section 406 of ERISA by reason of Section 408. See case cited at n.5, *infra*.

Second Reply Point

Congress did not intend to place the burden of proof on prudence on both parties.

In his response, Respondent:

1. concedes he has the burden of proof under Section 404 (Resp. 11);
2. acknowledges the court below made the prudence test of Section 404 and the good faith test of Section 3(18)(B) interchangeable (Resp. 9); and
3. argues that the petitioners have the burden of proving prudence in claiming a Section 408 exemption (Resp. 11).

Congress could not have intended both the Secretary and the fiduciaries to have the burden of proof on the issue of prudence.

This absurdity underscores petitioners' contention that the prudency and good faith sections are independent and that the latter does not include the former. The tax court case cited by respondent,[5] decided in the context of the IRS prohibited transaction tax, reflects confusion in this area. The tax court did not attempt to determine actual value, and therefore focused on "whether the *process* used . . . in determining the price conformed to established fiduciary standards."[6] The *process* the tax court focused on, after noting that "(t)o date, no regulations have been promulgated under section 3(18), ERISA",[7]

5. *Capital City Excavating Co. v. Commissioner*, 47 T.C.M. (CCH) 1527 (Apr. 18, 1984) (Resp. 9, n.5).

6. *Id.* at 1530 (emphasis supplied).

7. *Id.* at 1529, n.13.

was the taxpayer's reasonable adherence to valuation principles in the estate and gift tax regulations and in Revenue Ruling 59-60.[8] The court below rejected this approach (Pet. App., 20a and 35a-36a) and instead examined (by reviewing petitioners' trial testimony) how prudently petitioners investigated events subsequent to the Rotan Mosle appraisal to determine if adequate consideration was paid! A fair (and logical) reading of the tax court case will result in the conclusion that if the tax court had determined actual value, and found it to equal or exceed the purchase price, then it would have found no "amount" involved in a "prohibited transaction", regardless of the "process" used by the taxpayer in valuing the stock. This is so because the tax laws tax the transaction where the purchase price exceeds fair market value (but only where good faith does not exist)[9] and do not tax imprudent conduct. Accordingly, to be consistent, the district court's undisturbed finding on value ought to be conclusive of adequate consideration, contrary to the reasoning of the court of appeals.

Third Reply Point

Respondent cannot meet his burden of proof on the Section 404 issue with testimony from his biased expert.

Respondent contends he carried his burden of proving that the petitioners acted imprudently, based on "abundant factual support for the court's finding of a Section

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8. *Id.* at 1530.

9. See IRS National Office Technical Advice Memorandum, Pet. App., 86a.

404 . . . violation" (Resp. 11). Two events[10] occurring after the Rotan Mosle appraisal supposedly had negative value implications, according to the discredited expert offered by respondent. The "abundant factual support" referred to by respondent was this biased expert's testimony, which cannot be relied upon for any purpose (Pet. 22, n.25).

In finding imprudence, the court below relied on concepts developed by the discredited expert rather than following the clearly erroneous standard and focusing on the findings of the district court under that standard.

Fourth Reply Point

The undisturbed district court's finding on value is conclusive on the Section 406 issue.

Respondent fails to address the petitioners' point that the undisturbed finding of the district court on value requires entry of judgment for petitioners on the Section 406 charge. Rather, respondent argues that the court below "implied" the MCS stock was overvalued (Resp. 13).

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10. The two events were delay in achieving growth projected by management and relied on by Rotan Mosle, and the adoption of the ESOP. The growth projected ($4.2 million in f.y. 1975 to $5.8 million in f.y. 1976) for the fiscal year following the appraisal (f.y. 1976) was vastly exceeded ($5.6 million in f.y. 1977 to $12 million in f.y. 1978) in the fiscal year immediately following the sale (f.y. 1978), and the delay was explained at trial by the impact of a national recession on MCS's retail delivery service. The only evidence in the record that these two events negatively affected the appraisal value was testimony of the Secretary's biased expert. None of the gift and estate tax regulations or revenue rulings cited by the Secretary requires a reduction in value due to these two events. This is precisely the reason why Congress required the Secretary to publish rgulations—to guide fiduciaries in valuation *for ESOP purposes*, where traditional valuation concepts don't apply.

What the court of appeals *did* say was that petitioners failed to prudently investigate changes that had occurred since the appraisal report, (Pet. App. 37a), and which the court below apparently assumed may have had negative value implications based on the testimony of the respondent's discredited expert.

The court of appeals did not overturn the district court's finding on value (Pet. App. 66a).

Can it be unique to ERISA jurisprudence that fiduciaries who paid fair value can still be condemned for not paying adequate consideration?

If the decision below stands, petitioners, who were found to have paid fair value, will be punished for not paying fair value because they did not articulate in their trial testimony their investigation and evaluation of two events which a discredited expert said affected the value negatively.

Conclusion

The Petition For A Writ of Certiorari should be granted.

Respectfully submitted,

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June 8, 1984

Certificate of Service

I hereby certify that copies of the foregoing Reply were served on Respondent by mailing same by first class United States mail in a properly addressed, postage prepaid envelope on this the 8th day of June, 1984 to the following: Paula Page, Esq., U.S. Department of Labor, P. O. Box 1914, Washington, D.C. 20013 and to Rex E. Lee, Solicitor General, U.S. Department of Justice, Office of the Solocitor General, Washington, D.C. 20530.

C. LELAND HAMEL

APPENDIX A

* * *

ESOPs Are Of National Importance

3. ESOPs are important as a means of strengthening the free enterprise system. The need for broadened ownership of capital has been acknowledged by many leaders of our country. Among them is President Reagan who said:

> Could there be anything resembling a free enterprise economy, if wealth and property were concentrated in the hands of a few, while the great majority owned little more than the shirts on their backs? . . . Could any country be a land of free men and women, where the pride and independence of property ownership was reserved to the few, while the majority existed in dependency and servility? It should be clear to everyone that the nation's steadfast policy should afford every American of working age a realistic opportunity to acquire the ownership and control of property in a growing national economy. . . . The nation's next president should call upon Congressional leaders like Senator Long to work with him to ensure that all Americans have a fair chance to become owners of property.[1]

* * *

4. The beneficial impact of ESOPs on the motivation and productivity of employees has been well-documented. A 1977 report on employee-owned companies by the

1. Luis L. Granados, *Employee Stock Ownership Plans: An Analysis of Current Reform Proposals*, 14 U. Mich. J. L. REF. 1, 50 (1980) *citing* Reagan-Bush Committee Memorandum, Oct. 31, 1980 (on file with University of Michigan Journal of Law Reform).

* * *

Survey Research Center at the University of Michigan—sponsored by the Economic Development Administration of the U.S. Department of Commerce—found that companies with a substantial degree of employee ownership are 1.5 times more profitable than comparable conventionally-owned firms.[3] Similar results are reflected in a 1979 study of 72 companies with ESOPs sponsored by the ESOP Association of America. The typical ESOP company studied had been in business for 24 years and had established its ESOP three years prior to the study. During those three years, annual sales per employee increased an average of 25 percent, total annual sales rose an average of 72 percent, and annual profits grew an average 157 percent.[4] In addition, the results showed a close correlation between ESOPs and a growth in both employment and tax revenue.[5] A 1981 survey of 229 ESOP companies by the Journal of Corporation Law at the University of Iowa School of Law found that while other companies' productivity was declining during the 1975-79 period, productivity in ESOP companies was increasing.[6] In addition, one-third of the companies surveyed reported reduced employee turnover and improved quality of work.[7]

5. Congress has enacted many laws dealing with and designed to promote ESOPs. A sampling of such laws is set out in Exhibit "B". In addition to Congress, many states have also enacted laws intended to promote ESOPs;

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3. *Id.*, at S16630.

4. *Id.*

5. *Id.*

6. *Id.*

7. 129 CONG. REC. S16630 (daily ed. Nov. 17, 1983) (Statement of Senator Long).

for example, California, Delaware, Illinois, Maryland, Massachussets, Michigan, Minnesota, New Jersey, New York, and West Virginia.[8] In enacting the "Broadened Ownership Act", Maryland supports the establishment of ESOPs as official State economic policy.[9] Indeed, of such importance to the American economy is the widespread establishment of ESOPs that Congress found it necessary to codify its intent to encourage the promotion and establishment of ESOPs.[10] The decision below will significantly deter and discourage the establishment of ESOPs and thereby frustrate Congress' intent and efforts to promote ESOPs.

Why The Judgment Below Will Deter
The Formation And Use Of ESOPs

* * *

7. Valuation of employer securities of a closely-held company is a difficult task, recognized as such by both courts below.[13] Notwithstanding this fact, and the recommendation of the General Accounting office that such regulations be published,[14] and the acknowledgment of the Secretary that such regulations should be published,[15] no regulations from 1974 to date have been published.

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8. *Id.*

9. *Id.*

10. See the petition for writ of certiorari, page 11.

* * *

13. *Donovan v. Cunningham*, 541 F.Supp. 276, 284 (S.D. Tex. 1982); 716 F.2d 1455, 1473 (5th Cir. 1983).

14. *See* supra note 11, at 19.

15. Letter from Department of Labor to G.A.O., dated March 18, 1980, reproduced as App. F. to the petition for certiorari.

* * *

9. The fact that the Secretary has the power to challenge fiduciaries who cause an ESOP to purchase its sponsor-employer's stock, without committing himself to appropriate valuation standards in advance, is contrary to the intent of Congress . . .

* * *

10. In the future, what businessman, and which of the members of his management team, will be willing to serve as fiduciaries and face the rigors, expense, time, and damage to reputation of the sort experienced by these petitioners in this litigation, as well as the uncertainties inherent in attempting to follow the single valuation standard of "good faith" with the gloss placed on that term by the court of appeals? None. And without such willingness, ESOPs for closely-held companies cannot exist.

* * *

12. The errors in the judgment of the court of appeals are significant because they will deter the formation and continuation of ESOPs for small companies whose stock is closely-held. . . .

* * *

EXHIBIT "B"

1. Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1974).

2. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) [codified in scattered sections of titles 5, 18, 26, 29, 31 and 42 U.S.C. (1976)].

3. Trade Act of 1974, Pub. L. No. 93-618, 88 Stat. 1978 (1975) (codified in scattered sections of titles 5, 13, 19, 26, 28 and 31 U.S.C.) (as part of the relief package being established for companies that are members of foreign trade-impacted industries, provided that preference be given for assistance to such companies which adopt an ESOP).

4. Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of titles 26 and 42 U.S.C.).

5. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976) [established, and expanded, the availability of an investment tax credit for employers that adopt an ESOP (called a TRASOP) and which are otherwise eligible for the investment tax credit].

6. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978) (simplified many of the provisions relating to ESOPs and TRASOPs, made them more attractive to employers, and extended the TRASOP credit provision through December 31, 1983).

7. Pub. L. No. 95-611, 92 Stat. 3089 (1978) (in addition to the United States Railway Association authorization for 1979, mandated the creation of an ESOP by ConRail and the Delaware & Hudson Railway as part of their Federal funding).

8. Milwaukee Railroad Restructuring Act, Pub. L. No. 96-101, 93 Stat. 736 (1979) (required the establishment of an ESOP by the Milwaukee Railroad as part of its Federal assistance package).

9. Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324 (1980) (required the establishment of an ESOP by the Chrysler Corporation as part of the Federal loan guaranty program).

10. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) (provides tax incentives for leveraged ESOPs and PAYSOPs).

11. Small Business Employee Ownership Act of 1980, Pub. L. No. 96-302, 94 Stat. 833 (1980) (authorizes the Small Business Administration to provide loan guaranties to ESOPs for financing corporate growth).

APPENDIX B

(Barron's, May 28, 1984, pp. 30-31)

NO ESOP FABLE

Congress Acts to Spur Stock Plans

By Pamela J. Black

Ronald Reagan likes it. Gary Hart likes it. "Everyone from Tom Hayden to the Pope supports it," exults Corey Rosen, executive director of the National Center for Employee Stock Ownership. The object of all this affection is the Employee Stock Ownership Plan, more familiarly known as ESOP. Its fans see ESOPs as no-lose propositions: companies get tax breaks and employees get a free benefit.

ESOPs provide cheap financing for business, at the same time cutting workers in on the potential for capital gains. In theory, at least, employees with equity in their own companies will work harder; the interests of management and labor will be drawn closer. And since they're getting an extra slice of the pie, presumably workers will spend more and help stimulate the economy.

ESOPs sound so good, it's small wonder that 48 senators, spanning the political spectrum from Laxalt to Kennedy, are co-sponsoring a new package of tax incentives to foster their growth. Congress is expected to pass the bill before the summer recess and if it does, according to financial analyst and ESOP consultant Ron Gilbert: "There will be an ESOP explosion. Companies and professionals will be falling all over each other to learn about it."

At the instigation of Sen. Russell Long of Louisiana, the ranking Democrat on the Senate Finance Committee, Congress has enacted no fewer than 15 separate pieces of ESOP legislation over the past 10 years. In that time, the number of companies embracing the plans has climbed from a few hundred to over 5,000 involving an estimated three million employees. And the latest package of incentives—one of the most extensive to date—would provide a wide range of new tax breaks to companies that give shares to employees.

Not that ESOPs are universally praised. Some managements remain uneasy about giving workers any control, and labor grumbles that the plans don't give them *enough* control. AFL-CIO economist Arnold Cantor calls the claims that ESOPs increase worker productivity "sketchy and anecdotal." He complains ESOPs transfer risks to employees: "Workers should play the stock market if they have the money to." ESOPs have been "terribly, terribly oversold," he adds.

On the other hand, a 1983 survey of 229 ESOP Association members (admittedly, a less than disinterested group) found that 15% thought employee motivation and productivity were much improved under the plans and 56% figured it was at least somewhat better.

In any case, Sen. Long sees ESOPs as a gradual and painless way to transfer part ownership of corporate America from the haves to the have-nots. Thus, since '73, he's backed a series of increasingly generous tax incentives designed to encourage more businesses to snuggle up to an ESOP.

How do ESOPs work? Basically, companies form a trust into which they can annually contribute cash or

stock for employees. If the employer kicks in cash, the trust uses it to buy company shares. The employer then deducts the contribution from its taxable income. The company also can put stock directly into the ESOP—and claim the same deduction.

In leveraged ESOPs, companies can, effectively, borrow money through the trust and get deductions for both interest and principal. It works this way: The ESOP uses a loan from a bank, say, to buy company stock, which is allocated to employee accounts. The company's then free to use the cash as it wishes—to pay for expansion, a previous loan, or to buy out a major shareholder. It also makes annual tax-deductible cash contributions to the trust, so it can repay the loan. The lender initially holds title to the shares, which collateralize the loan, but ownership passes to the employees as the loan is repaid.

The latest carrot on the legislative stick was PAYSOP, a payroll-based tax credit worth one-half of 1% of annual payroll expenditures—providing that the savings go into company stock for employees. In effect, the government subsidizes PAYSOP companies for the full value of the shares they give to their workers.

Large labor-intensive companies, like AT&T, Dayton-Hudson, Sears, Roebuck and General Motors, were quick to adopt PAYSOP plans after the law went into effect in January 1983. According to a recent survey by Hewitt Associates, an Illinois-based benefits consulting firm, 62% of 648 Fortune 1000 companies surveyed have PAY-SOPS, and another 11% were considering them. "By the end of 1984 the vast majority of larger companies will have PAYSOPs," predicts financial analyst Gilbert.

"There's no reason not to. The government's just laid the money on the table."

But now a deficit-conscious Congress wants to table a scheduled increase in the PAYSOP credit, to three-quarters of 1%, which is supposed to go into effect next year. But most of what it's taking away with one hand it's giving back with another. The Senate Finance Committee has proposed what Louis Granados of the ESOP Association calls a "juicy but more cost-efficient" package of tax incentives. Altogether, its seven items would cost the federal government $400 million less, annually, than the planned boost in the PAYSOP credit.

Nonetheless, the bill would encourage owners or principal shareholders to sell their stock to employees, via ESOPs, rather than to outside suitors by changing the tax treatment afforded the profits on the sale. Currently, when an owner sells to another corporation, he can reinvest the proceeds in the stock of that concern without paying capital gains taxes. If, however, he sells to an ESOP, his profit is taxed. The new bill would address this, exempting profits plowed back into ESOP shares from capital gains.

A similar provision would grant majority owners who give their holdings to an ESOP the same tax breaks they now receive for donations to charitable foundations. "Some people want to leave their wealth to those who helped them create it," notes the ESOP Association's Granados, "and the law isn't presently set up for this." According to Jeffrey Gates of the Senate Finance Committee staff, this provision would lead to a more productive use of capital, rather than locking it up in a foundation where "that money can never be taxed again."

The bill also contains two estate tax breaks for major shareholders' heirs. One would allow them to gradually transfer their holdings to an ESOP, which then would pay off the estate's tax liability, piece by piece. The other would cut in half the estate tax due on profits from an outright sale of stock to an ESOP.

A fifth provision in the tax bill would encourage public investment in start-up outfits, if at least half the stock is owned by non-management employees. Outside investors who held their stakes in such companies for at least three years would have their capital gains tax liabilities cut 50%. According to Finance Committee staffer Jeffrey Gates, this incentive is designed to help the burgeoning high-tech industry, where many smaller companies may not yet have big enough staffs—much less earnings—to take advantage of current ESOP tax breaks.

The latest bill even offers an ESOP sweetner to banks. To entice bankers to lend to leveraged ESOPs, the bill would give lending institutions a 50% tax deduction on the interest paid on these loans.

Finally, the bill would let companies deduct dividends paid on ESOP shares from their taxable income. Many don't make payouts, simply to avoid the double taxation of dividends. Instead, they reinvest the payouts in the ESOP trust and dole them out to departing workers. According to the ESOP Association's Granados, the bill's dividend deduction provision should simulate productivity. Employees receiving regular cash payouts, he reckons, should feel a greater pride of ownership. As the company thrives, they receive a tangible cash reward—which they can, perhaps, increase by working harder.

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